#47, 20 December 1999
A publication of the International Centre for Policy Studies

ICPS newsletter

ICPS forecasts reform acceleration and beginning of economic growth

A new issue of ICPS's Quarterly Predictions journal will be published this week. In this issue we present readers our first forecast for economic development in 2001, and improve our predictions for 1999–2000. Real GDP will decline by only 0.8% in 1999. The main assumption on which we based our forecast for 2000–2001 is a radical acceleration of reforms and qualitative change of economic policy. Thanks to these two factors, Ukraine will avoid defaulting on its foreign debt. Major risks are the failure to implement effective administrative reform, and slow and non-transparent privatisation. For 2000 we forecast gradual economic growth of 0.5%. In 2001, GDP will increase by 2%

GDP in Ukraine stopped declining in the second half of 1999. Over the first ten months of 1999 GDP fell by 1.2% (compared to 3% in H1'99). Industrial production outpaced the GDP dynamic and increased by 3.1% in real terms. This positive change was predetermined by the following factors:

· improvement of the trade balance—Ukraine became a net exporter of goods and services due to the real depreciation of the hryvnia and better conditions in world markets;

· loosening monetary policy—an increase in real money supply allowed firms to meet their demand for money and accelerated retail turnover; and

· low economic indicators in Q3'98.

At the same time, the improvement of production indicators was accompanied by negative trends which cast future economic growth into doubt:

· a decline in investment, particularly foreign investment;

· deterioration of financial discipline—before the presidential elections the government subsidised firms with its ban on cutting off non-paying clients from electricity supplies; and

· firms did not see any improvement in business conditions, as the government continued to control activities of enterprises, delaying the introduction of fair "rules of the game".

We retain our negative forecast for economic growth in 1999, though GDP will decline by only 0.8%. An increase in industrial production (3%) will not compensate a decline in construction (-10%), agriculture (-3%), and services (-1%). This year, for the first time Ukraine will export more goods and services than it will import; meantime, investment will contract rapidly and consumption will fall sharply.

Ukraine's recovery after the "debt grip" of 2000–2001 will not be possible without acceleration of economic reforms, particularly administrative reform. To avoid financial crisis, the government must launch reforms during the next three months. If it fails to accomplish reforms, Ukraine will not receive foreign financing, so needed to make debt repayments in Q1'00. In this case Ukraine will not avoid the default, which will discredit the country in the eyes of its trading partners, discourage investment, and, what is worst, hinder the fundamental changes needed for economic growth.

Our forecast for Ukraine's economic development in 2000–2001 is based on the assumption that Ukraine will avoid defaulting its foreign debt. This will be possible if economic policy is substantially improved:

· **The government should clearly determine the priorities of economic policy.** In contrast to its passive reaction to changes in economic situation over the last few years, the government will determine economic policy priorities directly after the presidential elections. Conformity of economic development to these priorities will favour long-term growth.

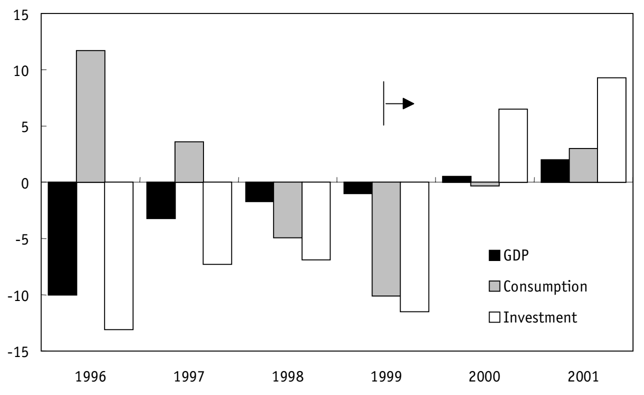
· **Budget policy will be strict.** The consolidated budget will be implemented with a surplus. The government will reduce subsidies to enterprises. This will drive domestic demand down, which, however, will be offset by growth in the private sector, due to lower demand of the government for financial resources.

· **Privatisation will accelerate.** We view cash privatisation, particularly with the participation of foreign investors, as a tool for increasing the effectiveness of firms' operations, rather than simply a means to repay debts.

· **World economy will grow.** In particular, Ukraine's major trading partners will develop dynamically. We do not forecast global or regional financial crises.

If the assumptions given above are valid, real GDP will increase by 0.5% in 2000. Even though consumption will not recover next year, investment will begin to grow. Foreign demand will remain high.

Figure 1. Real GDP, real consumption, and investment
Annual % change



Source: State Statistics Committee.
Forecast by Quarterly Predictions.

Last Week

Building institutional capacity of the government. Centre of Policy Excellence. A closing ceremony of the Centre of Policy Excellence (budget policy) project was held at ICPS on December 14. This project commenced in September 1998 with the financial support of USAID. The Centre of Policy Excellence (CoPE) training program on budget policy is an innovative form of technical assistance. The structured program focuses on building the Ukrainian government's institutional capacity for sound, sustainable, and judicious policymaking.

The Centre for Policy Excellence project is based on a partnership between the Ukrainian government, the American research organisation RAND, and ICPS. 13 representatives of the Ministry of Economy, the Ministry of Finance, and the National Bank of Ukraine took part in the training.

Project fellows' attention was focused on the process of policy analysis and developing capacity to perform policy analysis. The program had two primary components, i.e., (i) a fellowship program coordinated by Ms. Diana Cook (RAND), combining weekly seminars with individual study and work on a research project, and (ii) seminar series that brought together top policy analysts from around the world to discuss Ukrainian budget issues.

Mr. Ihor Shumylo, Deputy Minister of Economy of Ukraine, noted that CoPE is an effective investment for Ukraine's development, leading to the improvement of the quality of human resources in the Ukrainian government. Ms. Vira Nanivska, director of ICPS, believes that through implementation of similar projects in other ministries the development of public policy analysis in Ukraine will be qualitatively changed.

Publication of Country Economic Memorandum. A document titled "Participatory Country Economic Memorandum" was presented at the Kyiv World Bank Office on December 16. The Country Economic Memorandum (CEM) project is a joint activity of the World Bank, the Ministry of Economy of Ukraine, and ICPS. ICPS provided the research groups with organisational and methodological support and was the document publisher.

Traditionally, the World Bank's periodic economic studies on borrowing member countries, known as "Country Economic Memorandums," were written almost entirely by WB staff, using the country's government only as an information source. Clearly, under such conditions government officials would not be inclined to interpret a Memorandum as its own action plan. Last year the Bank decided to try a distinctly different approach in preparing a CEM for Ukraine. For the first time, a non-government organisation participated in the development of the document, and Ukrainian experts with the help of the Bank's advisors carried out the analytical research.

The CEM research team involved 350 experts working with standard methodology of policy analysis, i.e., determining strategic goals, problems and their causes, alternative solutions and their consequences, and strategy.

The *Country Economic Memorandum* includes three volumes:

· *Ukraine. Restoring Growth with Equity: A Participatory Country Economic Memorandum,* prepared by the World Bank staff;
· *Economic Growth with Equity: Ukrainian Perspectives*, prepared by Ukrainian experts;
· *Economic Growth with Equity: Which Strategy for Ukraine?*, prepared by John Hansen, Diana Cook, and ICPS staff.

According to Mr. John Hansen, a World Bank economic advisor, the analytical research conducted during drafting the CEM showed that the major factor of economic development of Ukraine is the role of the government. In the Soviet Union, the key function of the government was control, but today it should be facilitation of business activity.

ICPS Newsletter is a weekly publication of the International Centre for Policy Studies. To be included in the distribution list mail to: marketing@icps.kiev.ua.
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Stable industrial production will favour growth in agriculture, transport, and communications.

Accelerated structural changes in the economy will predetermine a real economic growth of 2% in 2001. An increase in real consumption will signal a decisive reversal of the declining trend.

Major indicators

	1998	1999 (forecast)	2000 (forecast)	2001 (forecast)
Economic activities				
GDP, millions UAH	103869	130400	156100	177600
Real GDP, annual % change	-1,7	-0,8	0,5	2,0
Real industrial production, annual % change	-1,5	3,0	0,5	1,5
Real agricultural production, annual % change	-8,3	-3,0	0,7	2,2
Gross investment, % GDP	20,7	18,5	19,6	21,0
Foreign direct investment, millions USD (1)	747	450	700	900
Real household disposable income, annual % change	-5,8	1,0	-3,0	3,0
Real retail turnover, annual % change	-3,5	-7,0	-3,0	6,0
Prices				
Consumer price index, annual % change	20	18,2	16,3	11,3
Wholesale price index, annual % change	35	17,7	13,0	10,8
Labour market				
Population, million people	50,1	49,8	49,4	49,1
Real wage, average annual % change	-2,8	-4,2	1,2	1,5
Official unemployment, %	3,7	4,5	6,0	9,0
Foreign economic activities (1)				
Exports of goods and services, annual % change	-13,4	-9,8	3,1	4,3
Imports of goods and services, annual % change	-17,0	-27,2	5,8	9,0
Current account balance, % of GDP	-3,0	5,4	4,3	2,4
Budget				
Current deficit, % of GDP	2,0	1,0	-0,8	-1,1
Primary deficit, % GDP (2)	-0,3	-1,7	-4,1	-4,3
Foreign debt, millions USD	10978	12100	11300	10500
Monetary indicators				
Monetary base, annual % change	22	29	19	15
M3, annual % change	25	32	21	17
NBU gross international reserves, millions USD	793	1300	1400	1600
Official exchange rate as of year end, UAH/USD	3,43	4,8	5,7	6,3
Weighted interest rate on loans, yearly %	55	57	50	40
International				
World output, annual % change	2,5	3,0	3,7	3,5
GDP growth rate in countries-major trading partners of Ukraine, annual % change	0,9	1,3	1,8	2,1

Notes:
(1) according to the NBU,
(2) calculated as current deficit minus foreign debt servicing
(3) commercial bank loans, in hryvnias

Source: State Statistics Committee, NBU, Finance Ministry. Calculations by Quarterly Predictions.